RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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May 4, DJIA 847.54; PTI 950; A-D Ratio –19.53

THE PICTURE: I'm not a mathematician, but I can add, subtract and divide. And I must say that I give a lot of thought to those weekly figures on our Government's financing. The national debt goes up at a rate of $1 billion or more a week. During the second half of this year our Government will need to raise an additional $35 billion, and there is talk of the Treasury coming up with a new 40-year maturity bond. In anticipation of this, most of the long end of the Treasury bond list has sunk to new historic lows, and yields are now readily available at 9.2% or better.

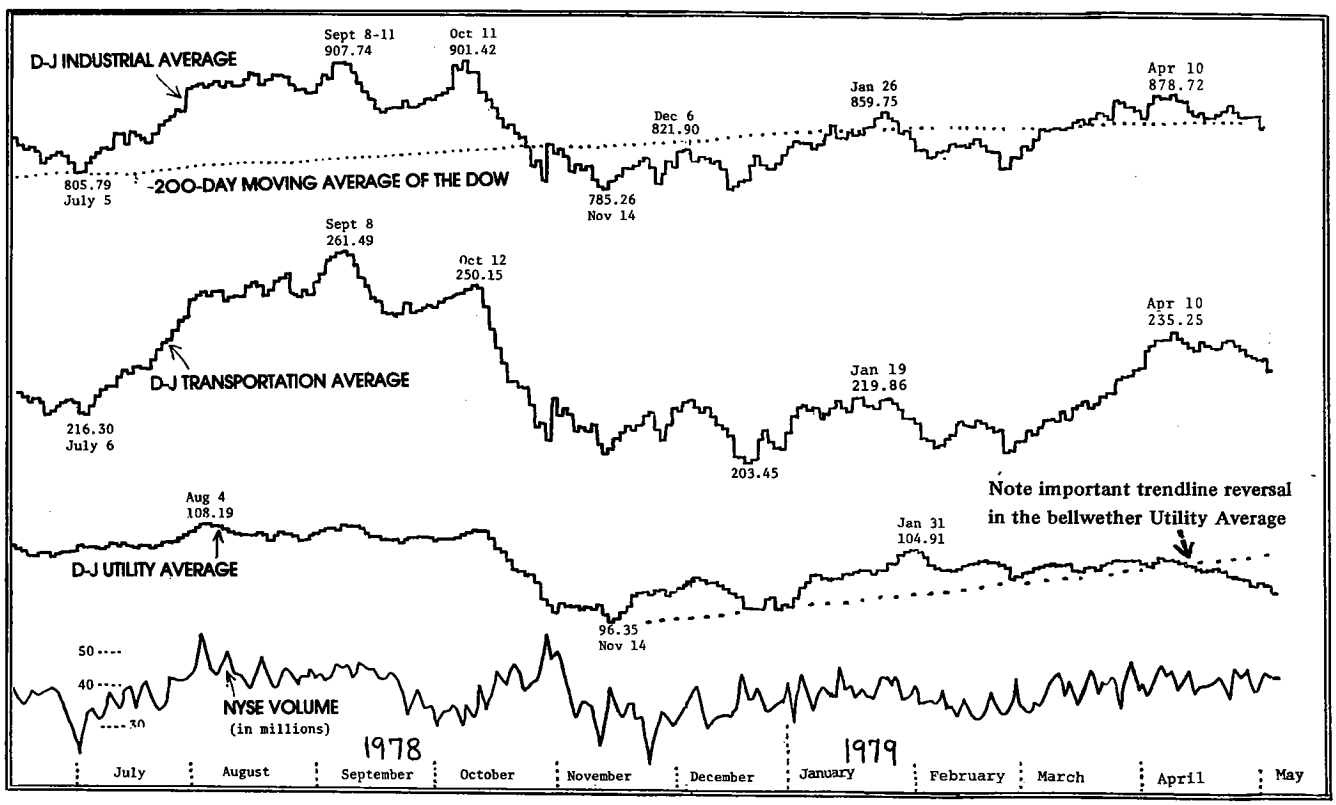
I sit here and I ponder, "How the devil is the US going to continue financing this rising debt year after year? How can this enormous and growing debt possibly be kept afloat?" And there seems to be only one way, and that way is indexing. In other words, as wages, prices, costs and debt move higher the whole incredible economic monster becomes an "indexing machine." The indexing or total inflationary process slowly wipes out all the lenders as their receivables become worth less and less. Finally, long-term bonds become impossible to sell and the entire debt moves into the shorter term area. And the short-term debt then rolls over at an ever-increasing rate.

Meanwhile, the markets, the stock markets, the commodity markets, the money markets. they all attempt to adjust to the indexing monster. As paper dollars become worth less and less, the price of stocks and things cost more and more. The rise in prices is slow and lethargic, pressed down by stagflation yet floated up by depreciating dollars. The bond market, seeing the destruction of values, drops lower. The long end of the bond market (subject to increasing skepticism) is gradually phased out of existence. Finally, bonds with maturities of more than five years are the object of derision–they are unsalable.

Front Page Comments: It's increasingly obvious that Carter, Miller & Co. are going to try to get past the 1980 elections WITHOUT a recession. Thus, Carter has staunchly predicted more inflation ahead, preparing us for the trouble. Carter and Miller are hoping the economy will slow down a bit, and they're playing it "on a wing and a prayer" right up to election-time. Fed Chairman Miller must be aware of the screaming deficits that this nation will incur during the next recession–and he wants no part of that nightmare. As to the three-month old 96th Congress, they're doing almost nothing–and finding that the public LIKES IT that way. "The less Congress does, the less they'll screw up the works." That's what the American voters are thinking; Congress senses it–and is obliging!

Is this the way it's going to happen? Is this the way it will look as the US economy slowly sinks into a sunset of unmanageable debt? I honestly don't know, but I must say that I am becoming increasingly dubious about the US's ever taking a sane approach to economics. With prices going up, bonds going down, inflation firmly established and the dollar printing presses still running, there's no question about it: we're following the indexing approach to debt elimination. Thus, the US is rapidly gaining the label of "the world's biggest banana republic."

What about the stock market? Won't the market adjust to the indexing away of all values? As I see it, the stock market is now



stuck. It's stuck in a most unusual and exotic way. On the plus side (technically) is the fact that everyone and his brother is predicting recession in the foreseeable future. My office is flooded with "the coming recession" articles, predictions and statistics. Worse, there's hardly a week goes by that I don't receive a new book on "The Coming World Collapse." Now mind you, I'm not saying that the outlook is pretty, but I don't think I've ever seen so much gloom so well advertised BEFORE THE EVENT. Last month the NYSE short interest rose to a record high. You can smell the corpse, but the patient just hasn't died yet.

On the negative side, the money markets are exerting persistent pressure on the stock market. Put it this way: you're a pension fund manager. You are studying the bond statistics, and you see all kinds of bonds readily available, at yields of 9.5% to 10.5%. How do you justify buying stocks at this point–stocks with yields of perhaps 2% to 5%. And on top of that we're here at the end of a 4½ year economic expansion with the possibility of a recession around the corner. The answer is that it's damn hard to justify buying stocks at this point. So you don't.

Thus, the technical situation is that the stock market has been holding up well in the face of gloom, recession talk and high interest rates. But the common sense of it is that it is almost impossible for a seasoned investor to justify a major position in stocks today. Result: stagflation in the stock markets which accurately reflects the stagflation in the economy.

But, you retort, look at all the liquidity around. Look at the hoards of money which are still begging to be invested. Look at the oceans of money to be loaned out. The banks have funds to loan, the foreign banks are moving in and trying to get into the consumer picture, and the S&L's are locked into a vicious struggle with the banks to make loans. The money is still available, you tell yourself, and recessions don't start when there is money to lend.

So 1979 must go down as the year of the great puzzle, the year of the financial waiting game. My own feeling is that the market (clever beast that it is) has been trying to outwait investors, daring them to come in, enticing them to come in, begging them to come in. And then . . .

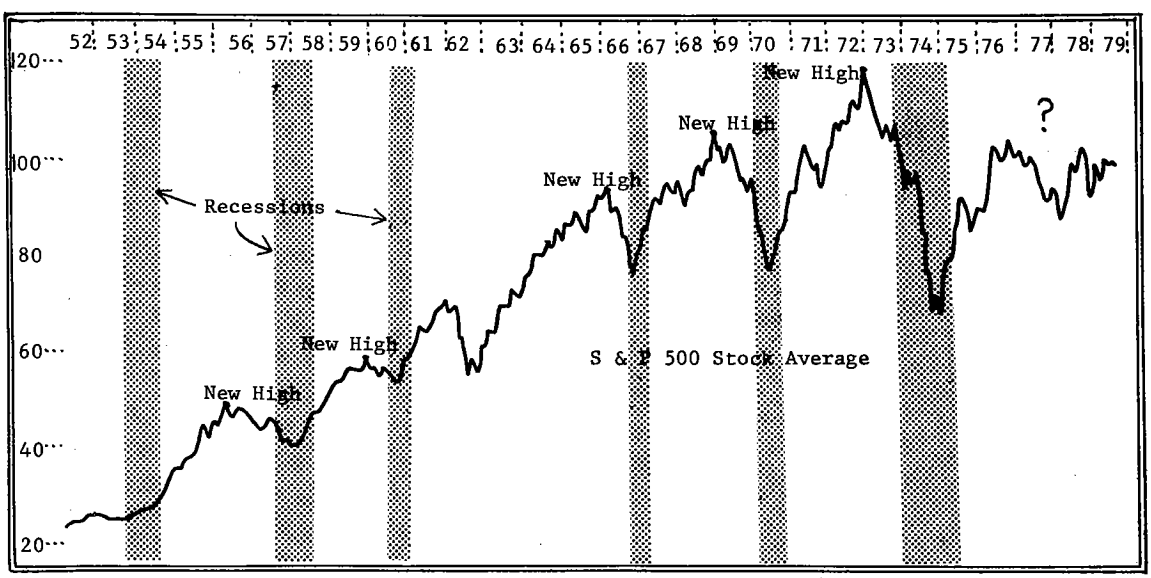
I've often said that the very large picture often tells us more than the near-by or very little picture. All right, study this chart of the broad Standard & Poor's 500 Stock Average. This is a monthly chart going back 27 years to 1952. What this chart shows is a very simple and basic process. The vertical bands of dots denote economic recessions. Following each recession, we see the S&P 500 move up to a new all-time high. We note this happening following the 1953-54 recession, the 1957-58 recession, the 1960 recession, the 1966 recession, the 1970 recession. Then we see the severe recession of 1974-75 and the recovery. But the S&P 500 topped out in September, 1976 and it has refused by a wide margin to better its 1973 high, a high made six years ago.

What is this chart telling us? Why is history not repeating here in 1979? My own theory is that the market is telling us that no amount of rising GNP, no amount of inflation, no amount of optimism can move the major averages up to new highs at this time. The market is telling us that there are powerful sellers, big sellers operating in this market. And despite all the buying that has been going on since 1975 the sellers have prevented the averages from advancing to or even near their old highs.

Does it matter why these sellers are operating? Does it matter what their reasons are for swapping stock certificates for cash? Sure it does, and I could list many of the reaons, and you could too. But the important thing to us as investors is the *process* and the *results*. The process of selling is continuing and the result is that the market has formed a ceiling.

From the practical point of view, it will pay us to wait (patiently) until the sellers finally overcome the buyers. That process should send the market down to lower levels. The point that will then interest me is the point at which the bears have fully expressed themselves. That level will be a buying level. Prudent and seasoned investors will wait for that level to be reached–and then buy.

In the last letter I mentioned that the odd-lot public has been selling heavily into this market. And I commented that the odd-lot public tends to be right about selling "high" markets and buying "cheap" markets. But there is another odd lot fellow who tends to be wrong. He is the odd lot short seller. He is a very speculative-minded trader, and he usually (erroneously) shorts most heavily near bottoms while reducing his shorting activities near the tops.



Whereas the odd lot short seller tends to be a loser, the specialist on the NYSE (who has access to the trading books) tends to be right in timing his shorts. When the specialists boost their shorting heavily, watch out–the market is in high-risk territory. Marty Zweig has worked out a ratio of odd lot to specialist shorting which has been extremely helpful in calling the turns. Dr. Zweig found that the ratio moves down around 30-35% near tops and up around 50% near bottoms.

Right now, the odd lot to specialists short ratio is 33%, which means that the odd lot shorting is on the low side while the more astute specialist shorting is on the high side. Thus, the stock market is in a high risk area at this time. The pros are betting that there's money to be made on the downside, while the speculative public is saying that "all is well."

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Turning to the page 1 chart of the Averages, the picture up to now has been the definite and persistent slump in the bellwether Utility Average. As I've said many times before, I've never seen a steady decline in both the Utility and Bond Averages that was not eventually JOINED by the rest of the market. It would appear that the rest of the stock market is in the process of joining the Bonds and Utilities now.

The Transportation Average has been slipping since April 10 while Industrials have been forming a little head-and-shoulder top with support at 852. On May 4 the market tumbled, and the Dow broke easily below the 850 level. From here on, the decline becomes of real interest and the question is–will there be follow through and real liquidation on the downside? My guess is that April 10 was THE top, and that 878.72 will stand as the Dow high for 1979.

INDICATORS: I think at one time or another I've run about every technical device, indicator and stock market barometer available. It's remarkable how a technical indicator will work well for a year or so or even many years. It develops a following and suddenly – it doesn't work any more. Perhaps the classic example of this is the famous "Confidence Index" (based on the ratio of bond yields). During the early '60's the CI had a tremendous following. Then it ceased to work properly–and it's now dead and forgotten (I still watch it, by the way).

Every analyst has his prejudices, and I guess my prejudice runs in favor of the "market action" indicators. These are the hardest indicators to fool; they are the indicators that are least apt to be deceptive. In this category are the price indicators, the averages, the A-D ratio, the most-active stock indices, the high low indices, and of course my primary trend index. All of these market action devices simply show you what has actually happened in terms of price and action. You've got to decide (based on intuition, past performance, probabilities, what have you) whether what has happened is going to continue, or whether it's going to end.

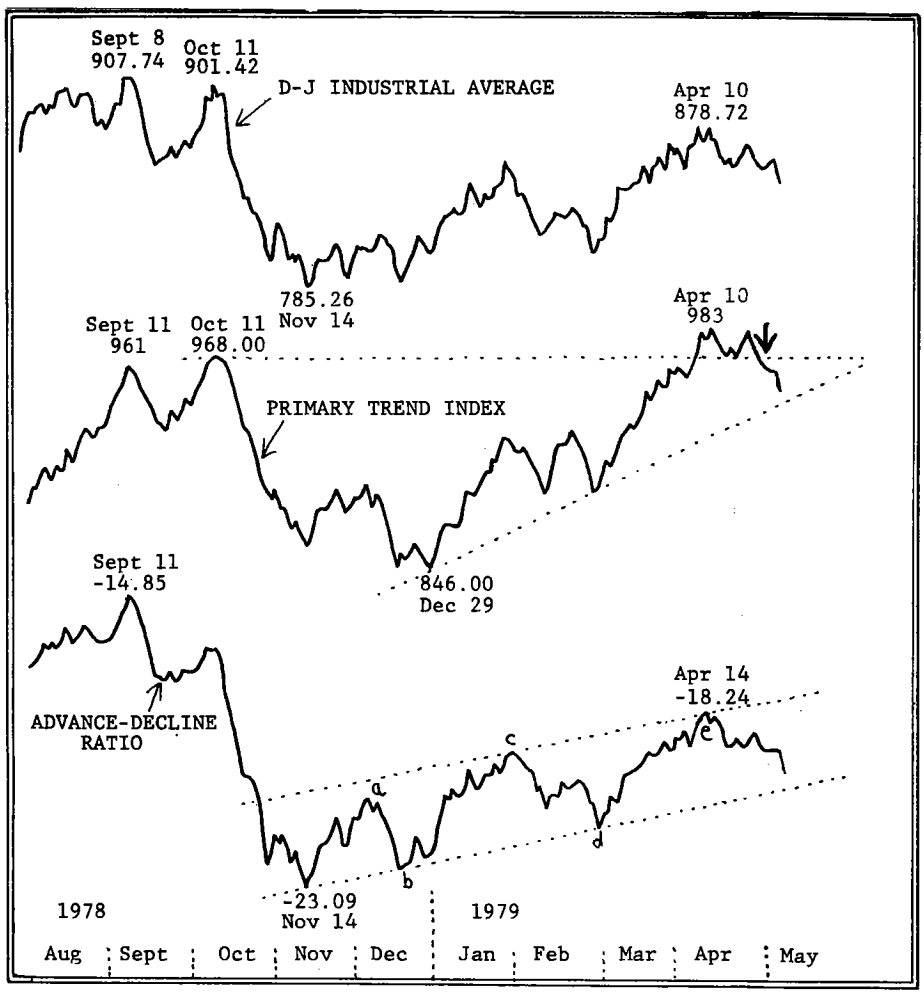
Lately I've been writing about the fact that the PTI (my own amalgam of eight critical indices and averages) is outperforming the Dow. Since the PTI is a technical composite, you can say that price (as exemplified by the Dow) has refused to confirm the technical syndrome (as exemplified by the PTI). This is a rather rare situation, and I have only seen it occur a few times in the last eight years.

In the last Letter I noted that the PTI has produced three successive higher peaks, the 961 peak (see chart) of Sept. 1, the 968 peak of Oct. 11 and the latest and highest peak, the 983 of April 10. Against that we have three lower peaks on the Dow, the Sept. 8 peak of 907.74, the Oct. 11 peak of 901.42 and the April 10 peak of 878.72.

Thus we have witnessed an outstanding divergence between price and the technical syndrome, and that suggests that there is "something seriously wrong in the guts of the market." The tug-of-war persisted with the Dow laboring and wanting to go lower, while the PTI pressed forward, trying to drag the Dow higher.

I have written that when the market indicators that have previously been **strongest** finally turn down, it is a signal for trouble. On April 27 the PTI broke below its preceding April low. In forming a downward zig-zag (see chart) the PTI evidenced its first sign of weakness. On May 4 the market finally responded, and a sweeping decline took the Dow to within a few points of its 200-day moving average (which now stands at 845). If 845 is decisively broken, I would think that the Dow would head for a test of 800.

At the bottom of the chart we see the profile of the A-D ratio, an indicator which acts like an unweighted average of all NYSE issues. The A-D ratio has been perched at about the midway level of its September 11 peak and its November 14 low. In the last Letter I noted that the A-D had been advancing within a rising channel. This channel was formed by a series of five waves, and the waves are marked a-b-c-d-e on the chart. Such movements usually end at the e-wave, and this appears to be the case now. The e-point was reached on April 4, as you can see on the chart. If so, we can expect an important move down, a decline that should shortly test, then penetrate the lower trendline of the

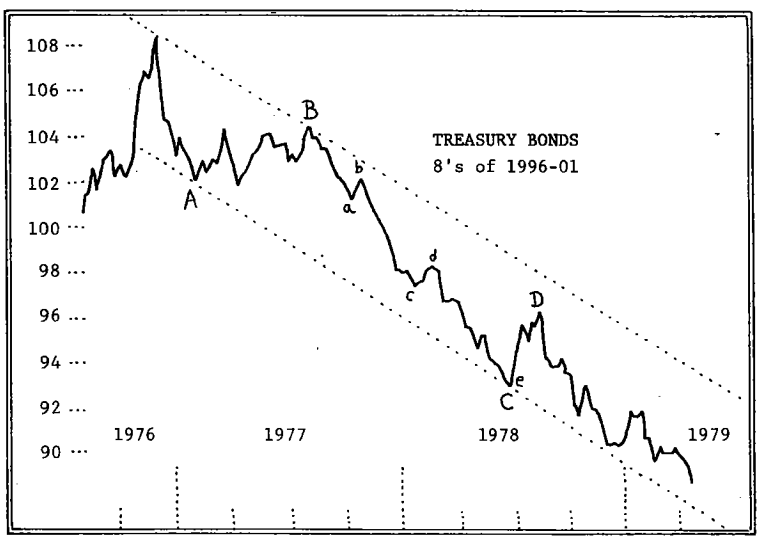


channel. Breaking the lower channel line, the A-D could then test its 1979 low.

Conclusion: Over the past few months I have felt that the market could best be likened to "a lead balloon held up by the hot air of inflation." This impasse should now be near the resolution point, and the resolution (as I have been suggesting) **appears to be down.**

BONDS: The bond market has not been a happy place to be in 1979. Let's take a typical Government bond, the 8's of 1996-01. I've followed this bond in these reports ever since the 108 peak of late-1976. On May 1 the bond sank to an historic low of 88½. At that price it provided a whopping yield of 9.21%. I've updated the chart of the 8's of 2001 to illustrate the devastating collapse that has taken place in long-term Treasuries.

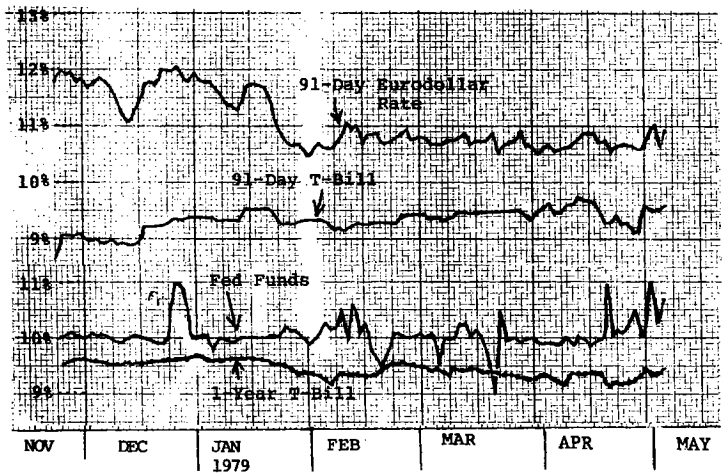
For months people have been asking me (at each step of the collapse) "should I buy the Government bonds here?" And I keep saying, "No, I don't think the decline is over, let's wait a while." Unfortunately, even at these prices, I'm not at all sure that the decline is over. And I say this even though this bond has declined over 18% in value since 1976, a cave-in which (taking into account all Treasury bonds) has cost institutions and investors hundreds of millions of dollars.



Note on the chart that the bond has been coming down in an A-B-C-D-E pattern with the E leg probably moving towards completion. The bottom of the channel is now at 87, and of course we don't know whether the bond is going to make contact with the lower trendline or not. But to me this decline still has an unfinished look about it, and I expect still lower prices. Discouraging news for bondholders, but then I've said that this isn't the time to hold bonds.

For the past six months we've been hearing rumors and predictions of an "end to the bond decline and a peak on interest rates." Even Fed Chairman Miller (a few months ago) offered his own "we're at the peak" prediction. But bonds have continued to decline. Ultimately, of course, we'll be at the bottom of this horrendous bond slide. But I need more evidence before I can say, "this looks like the bottom."

An interesting sideline to the bond market is the persistent and now very impressive strength in the dollar. With the dollar strong, foreigners will not have to follow "support operations" as they did last year (buying dollars to keep their own currencies from rising too far). In fact, foreigners are now selling dollars into the dollar strength. But here's the catch. Foreigners (by buying US debt) financed MOST of last year's deficits. It is clear that that's not going to happen this year. With up to $40 billion of deficits coming up in the second half of 1979, the **US is going to have to finance its own deficits**. . . That action could bring in renewed trouble in the bond markets during the second half of 1979.



If anything, there seems to be even more fascination with interest rates on the short end of the spectrum than the long end. Note my chart of four short-term rates. The 91-day Eurodollar rates are very important because this dollar market is outside the reach of the Fed. The peak in Eurodollar rates occurred last December at 12%. The 91-day bill rates have been pushing up, and these bills are very sensitive to the Fed Funds rate which is controlled by the Fed. The Fed has tightened the Fed Funds rate over the past few weeks, trying to get this rate to about 10.25%. At the bottom of the chart is the 1-year bill rate, and this is a rate which the Fed does not bother with and it is therefore a good indicator of true supply-demand in the bill market. So far, the 1-year bills have been holding steady in the 9.40% range.

NOTES & QUOTES: The CRB Commodity Index is within a hair of its all-time high recorded a few months ago in February. If this index "blows out" on the upside it will be telling us that the commodity markets expect a good deal more inflation in the period ahead. I watch lumber, silver and copper particularly closely, because the three comprise an excellent barometer of coming business conditions. So far, copper and lumber appear to be making tops. Silver is a tiger.

* *

San Diego now has the dubious distinction of having the highest average price for a new house in the nation, $97,300 by the latest count. I knew that sooner or later the "outside world" would find out about living conditions and climate (both tops) in San Diego. Thus, the new highs in home prices here. San Diego has also passed San Francisco in population (would you believe!).

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Here's food for thought: the budget of the Dept. of Health, Education and Welfare (HEW) is larger than any budget in the world with the exception of Russia's budget (and the US budget, of course). To justify it, HEW director Califano appears to have at least one press conference a day. I don't know which is more offensive, the size of the budget or the size of Califano's mouth.

* *

The most *misused* word in the US today is parameter. The correct word (look it up) is perimeter. Almost everyone uses parameter incorrectly....The most *overused* word in the US is viable. Would everyone please stop using that ghastly and absurd word!

* *

Since among other things this Letter deals with forecasts and predictions, I thought the following concept was too important to overlook. This excerpt is from Isaac Asimov's article on the "Elevator Effect" (from the Journal of NYC Planning Commission). The article explains brilliantly why forecasts of the future can go completely haywire. I thought subscribers would find the elevator principle as fascinating as I did.

Suppose this were 1850 and I were trying to picture the city of New York a century later. In order to help me, some kindly magician had given me a quick glance of a photograph of 20th-century Manhattan brought back in time for me and I therefore knew for a fact that the island would contain many buildings in excess of 10 stories in height and that at least one would be 100 stories high.

Given that, it would be my task to picture the details of a city in which this was so, using my 1850 experience for the purpose.

In the first place, it would be clear to me that climbing more than six or seven stories would be an arduous task and that therefore people who were once in the upper reaches of a skyscraper would be reluctant ever to leave it. Each skyscraper would therefore have to be as self-contained an economic unit as possible.

It would have to contain foodstores, tailors, barbers, taverns, gymnasiums and all the other appurtenances of civilized living—all duplicated periodically as one went up the skyscraper. Supplies would have to be hauled up pulleys operated by steam-engines and those supplies would be taken in at special doors placed in the side of the building at various levels. There would be no time of day or night when supplies of one sort or another were not being hauled up the outside of a number of skyscrapers.

There would be bridges from building to building at various levels, too, so that people could travel in a limited way without too much moving up and down.

Suppose people occasionally had to leave the building for social or business reasons. Those who lived in the bottom five stories would have little trouble and would be expected to pay premium rents in consequence. What of the proletariat in the upper stories, however?

There would be a spiral slide down which people could descend. It would be undignified and might give rise to vertigo and nausea among the unacclimated, but to the tower-dwellers, it would be an accustomed thing. Getting back up to the higher reaches of the building, however, would be very likely a half-day's journey. The wise person would allow for that and would stop every five stories at the lounge provided for the purpose, sit down, have a small drink, glance at the newspaper. Eventually he would make his way back home.

One could go on and on, building a rational picture in greater and greater detail, describing how the skyscrapers are built, of what materials they would be constructed, and so on.

The question is, though, would I think of the elevator? If I did not, the entire prediction would be wrong, completely wrong, ludicrously wrong.

And I think most people would not think of the elevator.

EGO: One of my difficult tasks is to try to teach subscribers to think like investors, rather than candy-store owners or crap-shooters (although even crap-shooters have to know the odds). I've never seen a market that wasn't accompanied by rumors and actual stories of this or that stock that "doubled over the past week." Study the chart books, and you'll find that there never has been a time (even during a market slump) when some stock wasn't spurting higher.

After 21 years in this business, I can also tell you that I've seen advisory services come and I've seen them go. Usually, the bigger the ego, the more dramatic the exit. As far as I know, none of the individuals running advisories in 1958 (when I started) are still running services today. Some dropped out, some were knocked out, some gave out, and a good many broke so many readers that they simply fizzled out.

The fact is that there are very few advisories or managers that can produce a 10% *total* return over a period of 10 or 15 years. They try, they may have many good years, they may have a few brilliant years, but when the final count is in–they don't make it. What happens? The market gets them or their methods get them, but most likely their own ego knocks them out of the investment box. Most advisors labor under the illusion that people pay them to be geniuses. If you're paying me or any other advisor to be a genius, forget it. Ask for a refund. There are no geniuses in this business.

Personally, I've learned the most from advisors who have promised the least. Or to put it another way, I've found that the bigger the promise, the smaller the return. The bigger the boast, the smaller the payoff.

But the pressure is ALWAYS on in the advisory field (often, the analysts simply put the pressure on themselves), and I almost never read a report that doesn't recommend some stock or other–REGARDLESS of what the market is doing. And that's one of the major reasons why advisory services don't last. They invariably try to give more than they are capable of giving. They can't resist promising more than they can come up with. The result is that the readers either lose money, lose patience or lose faith.

The great playwright, Hendrik Ibsen, once wrote "The strongest man in the world is the man who stands most alone." I would suggest that every advisory service owner and every investor study that sentence. Etch it into your brain. To understand the essence of that statement is to know the secret of surviving in the investment world.

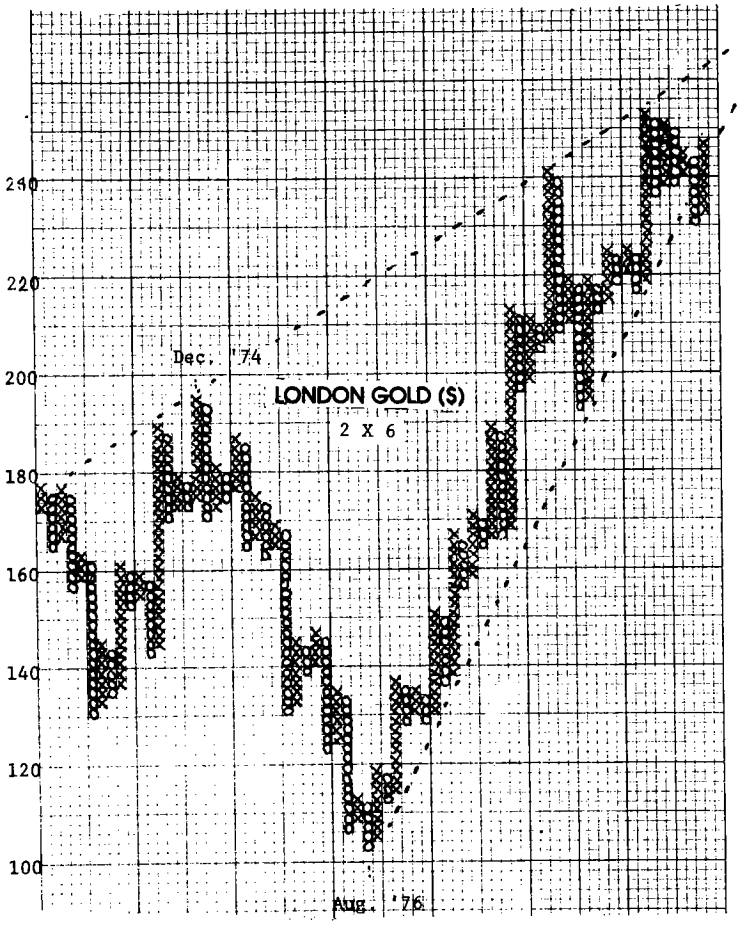
Right now short-term money is bringing in returns of 9.5% to 10%. That's a higher rate of return than the great, great majority of professionals (banks, pension funds, institutions) have been able to provide over the last 10 or the last 20 years. "The hell with that," you say, "I can beat 10% in the stock market. Why 10% doesn't even cover my loss of purchasing power due to inflation."

To which I answer, I doubt whether at this time you can beat 10% in the stock market. The odds (judging from other periods when money was very dear) say that you can't. And if you are lucky enough to beat 10% this time, you'll lose that and more next time you try. As to the loss of purchasing power due to inflation, nobody ever promised you that you'd stay ahead of inflation **at all times**. Right now, if you hold Treasury bills (yielding 9.5%) you're losing maybe 4% a year in purchasing power due to inflation. So what! Put that down to the cost of following correct procedure.

If we get a major sell-off this year (or even next) and you get a chance to buy stocks at bargain prices at a true over-sold bottom, then you may make 10% to 50% on your invested capital. But you'll be playing with the odds on your side and the probabilities on your side.

The guy who jumps in to buy "something that may double" just because he insists on beating inflation is a fool and a gambler. The chances are that before it's over he's going to learn that you don't beat the market or anything else by being stupid and impetuous. Inflation, like the stock market, couldn't care less whether you beat it or not. Nothing in investing takes the place of CORRECT PROCEDURE. And if you think that the stock market owes you a living because inflation is hitting your pur-

chasing power, well, all I can say is have a try at beating the market brother. And you might write me about a year from now and let me know how you've fared.



GOLD: Gold has moved up to the 248 area, and is now challenging its February 22 peak (2nd London fix) of 252.35. "Market Vane" runs a weekly bullish-bearish consensus on gold and other commodities, and the bullish consensus on gold is now very high–80%. The last time the bullish consensus was in the 80% area was February, at which time gold topped out.

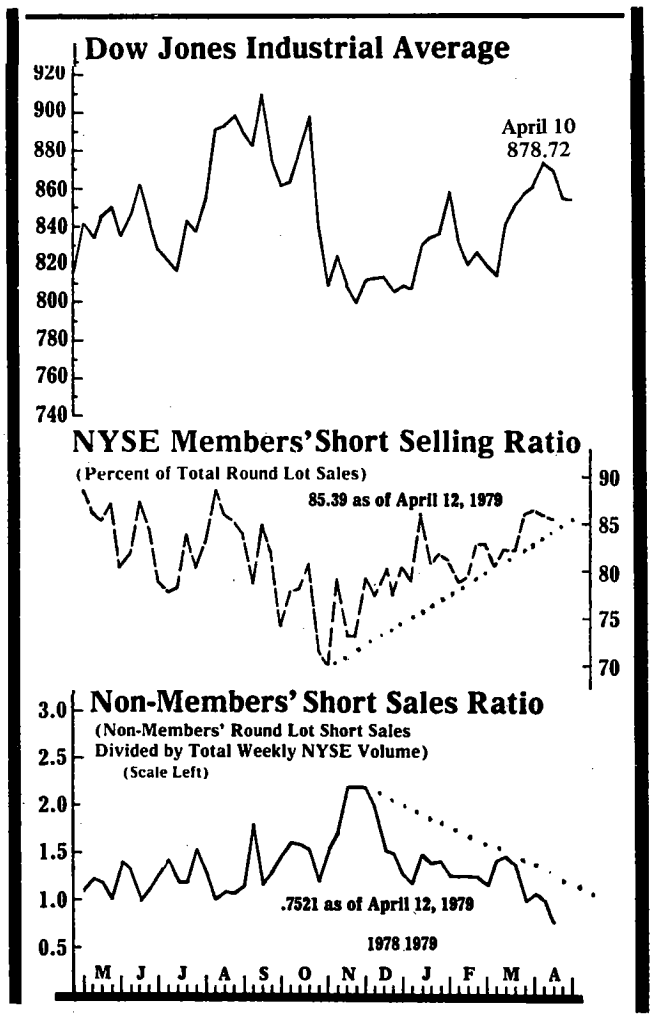
My 2 X 6 point & figure chart shows every rally or decline of 6 points or more in gold, with each box equalling 2 points. You can see that on Friday, May 4, gold moved to the 248 box, thereby bettering the preceding row of X's (at 246) and turning gold's trend bullish. An upside breakout would come at 256, and such a move would take gold to a new record high.

I have drawn in two rising trendlines, one through important lows since 1976 and one through important highs since 1974. On the most recent decline, gold broke below the lower trendline, but the metal quickly re-established itself above the lower trendline. Note that the price movement has now taken the form of a huge "rising wedge" pattern. The gold price will reach the apex (point) of this wedge quite soon. As a rule, I am very wary of price movements that take the form of rising wedges, since such patterns usually imply a slow drying up of buying power. Nevertheless, gold should be given the benefit of the doubt in this area, since the immediate trend is bullish.

It is clear that there have been many shakeouts and reactions since last year's violent correction to the 193 level. The upside progress since then has been slow, labored–but determined. My feeling is that at 250, gold is no longer a real inflation hedge, rather it is a chaos hedge and a survival hedge. Thus, I have been advocating about 10% of assets to be placed in gold coins with the rest of one's assets to be placed in 91-day Treasury Bills.

LATE NOTES: I wrote this in the last Letter, but the picture is now so fascinating that I want to update it. This chart is from M/G Financial Weekly. It shows the knowledgeable members' short selling ratio and the rather amateurish non-member or public short sales ratio . Note that Stock Exchange members have been increasing their shorts ever since last October–to a recent mid-April peak. Conversely, the non-member public has decreased its shorting activities to a very low mid-April level.

In other words, the professionals have been shorting the devil out of the market while the amateur public is convinced that there's no money to be made on the downside. As you know, the Dow made its 1979 high on April 10 at 878.72. It will be fascinating to see who is correct from here–the pros on the NYSE or the amateurs on Main Street.



The New "J. C. Penny"
(Courtesy of *Forbes*)

NEXT MAILING: May 23rd